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The 2004 Budget: bigger or better?

The 2004 State Budget reflects the policy of a Government that is too slow with reforms because it is afraid to take on responsibility for implementing radical changes. Last year, the Government of Ukraine failed to benefit from favourable economic conditions to undertake serious reform of the public sector. In 2004, reforms are unlikely to galvanise, since Government resources and efforts will be focused on the election campaign

In early 2004, several laws regulating relations between the public and the government went into effect simultaneously. Individuals will pay less income tax, a new procedure will be instituted for calculating pensions, and businesses will pay fewer profit taxes. At the same time, however, the public sector itself will undergo little change.These are the partial reforms reflected in the 2004 Budget.

Back in the summer, it seemed that much-needed reforms to the economy were finally on the fast-track. In December 2002, a law was passed that cut the corporate profit tax from 30% to 25%; in May 2003, following Russia's example, a flat 13% income tax rate was set; in July, a law was passed that altered the basis for the pension system. However, it looks like the list of progressive innovations halts at that point. The reason is the Government's inability to undertake tasks involving complex calculations, precise assessments and effective planning and its unwillingness to undertake unpopular measures. Yet this is the kind of work that is necessary to reform the nation's healthcare and education systems, its social security system, and so on. In the complete absence of public sector reforms, the budget law stands no chance of fulfilling its intended purpose any better.

Reforms undone

Plans to replace various subsidies with targeted assistance never got off the ground. The reason for the stall is the Administration's inability to take responsibility for effectively undertaking such large-scale reform. Shelving this important change means that budget resources will not be used more efficiently, after all, and the current unfair system of public assistance will remain in place, impeding successful reforms in other public sector areas.

Pressure from the World Bank and the IMF spurred the Government to resolve the problem of **VAT reimbursements to exporters**. As of November 1, 2003, 6 billion UAH were slated to be reimbursed, of which 3.2 billion UAH are arrears. The 2004 Budget states that overdue arrears on VAT reimbursements owed by the budget will be covered through an issue of domestic T-bills. However, this will only resolve the question of old debts; nothing has been done to prevent new accumulations of VAT debts. Comprehensive measures to resolve the problem once and for all have not been approved and there is no formulated Government programme currently available to the public, even on paper. This gives reason to believe that no such programme will be ready for launch in 2004.

The elimination of tax breaks sparked heated debate during the budget process. A reduction in such breaks would increase budget revenues, fulfill certain conditions for WTO accession, and ensure a level playing field for businesses in Ukraine. But the move to take away tax breaks is hampered by special interests and by the absence of an effective alternative source of state subsidies to sectors that justifiably merit government assistance. The Government does not have a gradual program for removing tax breaks, which meant that they were either stopped or extended without notice at YE'03.

A quality budget needs a quality approach

The making of the last Budget was notable for numerous amendments to tax legislation. But some part of these amendments has been incorporated into the law on the budget, which is against the Budget Code, according to which all amendments to laws affecting the revenue side of the budget must be published by August 15th. This typical flaunting of the Budget Code leads to ill-formulated laws being passed and heightens the risks of doing business in

Ukraine. Even if amendments to tax legislation were only debated, but not passed, this kind of ambiguity in a market economy carries enormous costs.

This year, for the first time, the budget process was accompanied by public hearings. However, what transpired could hardly be called a “dialogue” with the Government. For one thing, there was no common language: public finance is complicated, requiring special training and a long time to make sense of it. This is entirely normal and natural. But in the absence of influential independent experts who might have interpreted the language of budget finance for the average Ukrainian, such a dialogue was doomed to fail. In general, it is very difficult for the average citizen to communicate with professionals in government office without a go-between. But the opacity of the Ministry of Finance and the State Treasury thwarts the efforts of independent experts. In the end, the quality of the Budget suffers.

During debates over the draft 2004 Budget, the Government often mentioned the share of GDP re-distributed through the budget as an indicator of the success of its budget policy. In 2002, this share constituted 27.7% of GDP, while in 2003 it should be around 28%. The Government believes that, by increasing the level of re-distribution, it will be able to boost social benefits, raise the minimum wage to a minimum livable level, and finance capital investment.

However, research shows that expanding the public sector (in particular, the share of GDP re-distributed through the budget) has a questionable impact on economic growth. True, in economically developed countries, the public sector is generally bigger than in other countries. Still, there is no evidence so far as to whether economic growth results from the expansion of the public sector, or the public sector expands as a result of GDP growth. To claim that transition economies might accelerate their development by expanding their public sectors is quite incorrect.

In short, state policy priorities in Ukraine need to be based upon less questionable indicators. One such indicator, for instance, could be the quality of public services. Without quality transformations in the public sector, even increased financing to a particular sector (which the Government continues to take credit for) is no achievement: an unreformed sector is capable of eating up enormous resources without any noticeable positive effects.■

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How the 2004 Budget differs from its predecessor (billion UAH)

	2003 (plan)	2004 (plan)
Revenues	53.2	60.7
Expenditures	55.8	64.1
Deficit	2.6	3.4

- The 2004 Budget is calculated using the new tax base.
- Privatisation proceeds are planned to be slightly lower than in 2003, but financing from other sources has been increased.
- Local budgets will receive a bigger share of the central budget to compensate for the drop in revenues from personal income taxes.
- The minimum wage is now 205 UAH, rising to 237 UAH in November 2004.
- Military and law enforcement personnel will pay income tax starting in 2004.
- In 2004, fees for using state funds will increase.

Sluggish reforms cost more

The Yanukovych Government calls tax relief “one of our priorities”. By reducing taxes, the Government hopes to draw a large part of the economy out of the shadows. But unavoidable decreases in tax revenues to state coffers—at least immediately after the cuts—need to be offset somehow. A steep drop in revenues can be counteracted by introducing tax relief gradually. Another option is to simultaneously conduct the tax reform and cover the deficit, which will rise steeply, through foreign borrowing and other sources of financing.

The Government chose the first option. But ultimately this option is likely to cost Ukrainian society more than the second one. The experience of the past decade has consistently shown that overly sluggish reforms make it impossible to effectively solve problems as they accumulate.

Controlled increases in foreign borrowing in support of more rapid reform are the most acceptable solution to this particular problem. As an example, Eastern European countries are more inclined to use credits as a way to optimize consuming both “today” and “tomorrow”. Thus, in 2002, budget deficits reached 9.9% of GDP in Hungary, 6.2% in Croatia, 5.7% in Poland, and 5.5% in Slovakia. This is not to say that Ukraine should copy the policy of its nearest Western neighbours, but it does point to tools that Ukraine can use to conduct necessary transformations in its own economy. After the fiscal shock of 1992–1993, when Ukraine’s deficit hit 16–25% of GDP, there developed an attitude that *any* budget deficit is extremely undesirable. Borrowing, however, is a useful tool, albeit one that should be used with caution. In Ukraine, economic reforms are being financed by sources that will ultimately cost the society much more than borrowing.

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